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C O N F I D E N T I A L SECTION 01 OF 02 KUWAIT 003718

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STATE FOR NEA/ARP, EB/ESC/IEC; ENERGY FOR WILLIAMSON

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TAGS: EPET ENRG ECON KU OIL
SUBJECT: GRIM PROSPECTS FOR PROJECT KUWAIT

Classified By: Ambassador Richard LeBaron for reasons 1.4 (b) and (d).

¶1. (C/NF) Summary: The Head of Kuwait's Oil Development Company (ODC) said it was unlikely that the Kuwait Project, the $8.5 billion project for international companies to develop Kuwait's northern oil fields, would be brought before the Parliament this year. He said that support had significantly eroded in recent months after the Parliamentary elections and the replacement of the embattled former Energy Minister. The ODC chairman explained the structure of the contract and said that, once determined, the new fees would be more favorable to the bidders. Moreover, he said it would likely be possible for international partners to book the reserves. In separate meetings, representatives from International Oil Companies (IOCs) expressed pessimism and thought it unlikely that, if approved, the contracts would offer appealing terms and conditions. End Summary.

Lost Opportunities

¶2. (C/NF) On 13 September, Econoff met with Hashim El-Rifaai, Chairman and Managing Director of Oil Development Company. (Note: ODC was established in 2005 as the subsidiary of Kuwait Petroleum Corporation (KPC) responsible for overseeing any future operations involving international oil companies in Kuwait, especially the $8.5 billion Project Kuwait which would invite IOCs to participate in the development of four of Kuwait's northern oil fields. End Note.) El-Rifaai explained that the best opportunities for Parliamentary approval of the Project had been lost. He said that at the end of 2005, all of the votes were in place but then the Amir died in January before the legislation could be brought before the Parliament. During the spring, momentum was building again towards approval when the new Amir decided to dissolve the Parliament in May over a political redistricting issue.

"Back to Square One"

¶3. (C/NF) El-Rifaai says that now, after the June elections gave a parliamentary majority to the pro-reform Opposition, "Everything is back to square one." He said, "The Opposition is stronger, the Government is weaker, and the new Energy Minister is weaker than his predecessor." (Note: The Energy Ministry is currently under heavy fire from both the Parliament and the press over electrical blackouts and water shortages, septel. End Note.) El-Rifaai doubts the Project will have enough votes to pass in the near term. He added that on 12 September, the Petroleum Workers Union had announced its opposition to any Government plans that would diminish sovereign control of the northern fields. El-Rifaai says there is also significant opposition within KPC on the part of engineers who are unwilling to concede that they lack

the in-house capacity to manage the development of the difficult northern fields and need the capital and expertise of the IOCs. He says these engineers are feeding information to Opposition MPs in order to undermine the Project. He thinks it unlikely that the issue will be brought before the Parliament before January 2007.

An Uphill Battle Ahead, but Strategically Important
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¶4. (C/NF) During the election campaign and now again in recent weeks, some opposition MPs have expressed their resistance to the Project, suggesting that it is economically unnecessary and politically dangerous to allow foreign companies to take a stake in Kuwait's most precious resource. (Note: Kuwait's Constitution forbids foreign ownership of Kuwaiti oil. End note.) Furthermore, during the campaign, former Energy Minister and champion of the Project Ahmed Al-Fahd was accused of corruption and a lack of transparency in preparing the contracts. El-Rifaai showed Econoff a binder he had prepared for the Energy Minister to rebut each of the challenges made by MPs, clarify the economic and strategic basis for the Project, and spell out all the terms and conditions of the proposed contracts. He expressed frustration at the allegations of corruption and dissimulation saying, "This is the most transparent project that I've ever worked on!" As for the strategic value of the project, El-Rifaai said it was necessary to significantly increase production in the northern fields in order to be able to "rest" the massive and aging Burgan field so that it would be able to serve as a source of surge capacity in the future. A twenty-year veteran of KPC, El-Rifaai confessed that the company did not have the ability to develop the difficult northern field on its own.

Questions over Terms and Conditions

¶5. (C/NF) Under the 20-year contract, IOCs' compensation would consist of five different fees: a fixed price per unit of gas produced, a low fixed price per unit of oil produced up to the current KPC production levels, a higher fixed price per unit of oil produced in excess of the current KPC production levels, 50% of operating costs, and 50% of capital costs repaid over 10 years. El-Rifaai suggested that the contracts had been structured and worded in such a way as to allow IOCs to book proven reserves per the SEC definition without actually owning the oil in the ground. (Note: Econoff had recently heard the same from IOC reps from two of the Project Kuwait consortia. End note.) When Econoff asked whether he thought these terms would be attractive to IOCs, El-Rifaai responded that the actual fixed prices in the contract had not been revised since 2002. He said that although the new numbers had not yet been determined, there would be a significant upward revision from the 2002 fees to make the terms much more appealing to IOCs. He cautioned, however, that the new fees would have to be approved by the Council of Ministers before going to the Parliament.

IOCs Pessimistic

¶6. (C/NF) In recent meetings with local heads of ExxonMobil and Chevron, Econoff was told that compared to other international opportunities currently available, the 2002 terms of conditions of the Kuwait Project made it an unattractive investment. Exxon went so far as to say it would offer a negative rate of return. Both contacts indicated the ability to book reserves would be an essential starting point, and that beyond that the value of the contract would depend on how much the Kuwaitis were willing to adjust the fees. Both contacts said that IOCs were losing patience with the GOK and had little confidence that, if approved, the contracts would offer favorable terms and

conditions. That said, all the IOCs in Kuwait are exploring different business arrangements with the Kuwaitis to work on their particular technical specialties, and some are engaged in profitable technical service agreements.

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LeBaron